

used by the Budget Committees to measure the savings to be achieved by the reconciliation legislation.

CBO has made similar use of baseline budget projections in its bill cost estimates for calculating the costs or savings that would result from legislative proposals to change existing law. This is particularly important for calculating the budgetary effects of changes in various entitlement programs, such as Social Security benefits, medicaid, veterans' pensions, and federal employee retirement programs.

PLAN OF THIS REPORT

Chapter II provides an overview of the baseline projections for revenues, budget authority, and outlays for 1982-1986. It begins with a discussion of the economic assumptions used for the projections, presents the baseline spending and revenue projections, and describes the tax and spending cuts that are assumed in the first budget resolution for 1982 in terms of changes from these projections. The second chapter also describes the sensitivity of the baseline projections to economic assumptions and how the projections would change under an alternative set of assumptions.

The third chapter provides further detail on the revenue projections, showing projections of baseline revenues by major source. It also presents an alternative baseline projection that adjusts individual income tax receipts to remove the effects of the interaction between inflation and the progressive income tax structure. Since the Congress has from time to time enacted tax reductions that have offset a substantial amount of this interaction, referred to as "bracket creep," this alternative baseline revenue projection is useful for policy planning purposes. In addition, the chapter discusses the tax cuts assumed in the first budget resolution for 1982 in comparison to the baseline revenue projections.

The fourth chapter provides further detail on the baseline spending projections, showing the distribution of the spending projections by major program categories and by function. It also compares the projections with the first budget resolution to highlight the policy changes assumed to be made during 1982-1984.

The appendixes to this report contain a distribution of the baseline spending projections by committee jurisdiction, a translation of the projections and the first resolution targets into national income and product account terms, and a more detailed description of the programmatic assumptions contained in the defense baseline projections.

CHAPTER II. BASELINE BUDGET PROJECTIONS

This chapter presents estimates of what would happen to the federal budget over the next five fiscal years--1982 through 1986--under specified economic assumptions if spending and taxing policies were continued unchanged. It also compares these baseline, or current policy, projections with the budget totals for 1982-1984 specified by the First Concurrent Resolution on the Budget for Fiscal Year 1982 (H. Con. Res. 115) approved by the Congress on May 21, 1981.

Baseline budget projections typically have the following characteristics:

- o Projected revenues grow more rapidly than the economy because of the progressive nature of individual income taxes.
- o Projected outlays grow at a slower pace than the economy because little or no increase in spending in real terms is assumed for a large share of the budget.
- o The projected baseline budget begins to show a surplus within the five-year projection period because revenues grow faster than outlays.

Baseline projections are clearly not a forecast, since future budgets will contain changes in spending and tax policies in response to changes in the economy and in national priorities and needs. In the past, such changes have typically included tax cuts and spending increases from the baseline projection levels. As a result, the federal budget has continued to remain in deficit since fiscal year 1969.

ECONOMIC ASSUMPTIONS

Inflation, unemployment, interest rates, and economic growth have major effects on federal budget revenues and outlays. Tax receipts depend primarily on nominal incomes, which reflect both real economic growth and inflation. About 30 percent of spending is directly indexed for inflation through automatic cost-of-living adjustments. In the absence of major budget cuts or program increases, the remainder of the budget typically keeps pace with inflation through specific Congressional actions or in

response to rising costs of providing government services. The costs of certain benefit programs, such as unemployment insurance and food stamps, also depend on the level of unemployment in the economy. The costs of interest on the public debt depend on the level of interest rates. In order to develop budget projections, therefore, explicit assumptions must be made about economic trends over the next several years.

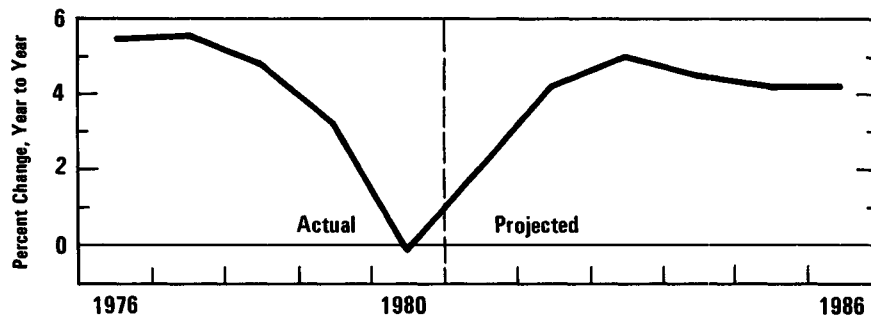
The levels of output, incomes, inflation, unemployment, and interest rates used for the baseline projections are shown in Table 1 and displayed in Figure 1. The assumptions for calendar years 1981-1984 are the same as those used for the conference agreement on the first budget resolution for fiscal year 1982. They also closely correspond to the economic projections assumed by the Administration for its fiscal year 1982 budget revisions that were submitted to the Congress in March, except for the interest rate assumptions and certain modifications to reflect actual experience during the first quarter of calendar 1981. The assumptions for calendar years 1985-1986 are CBO extrapolations of the 1981-1984 conference agreement assumptions; they also closely correspond to the Administration's March budget revision assumptions for those years.

TABLE 1. BASELINE ECONOMIC ASSUMPTIONS (By calendar year, dollar amounts in billions)

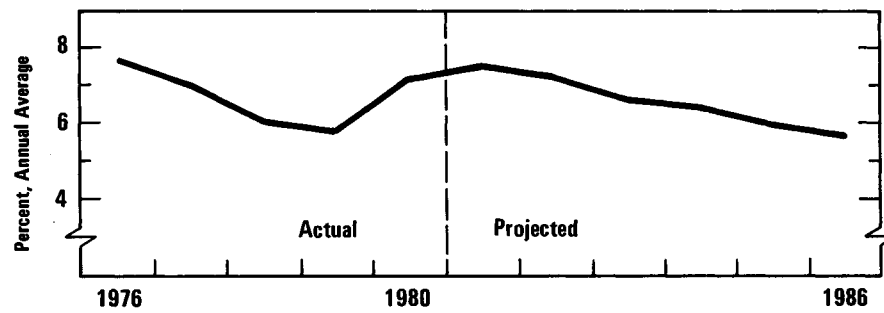
Economic Variable	Actual 1980	First Budget Resolution				CBO Extrapolation	
		1981	1982	1983	1984	1985	1986
Gross National Product (GNP)							
Current dollars							
Amount	2,626	2,941	3,323	3,734	4,135	4,541	4,963
Percent change, year to year	8.8	12.0	13.0	12.4	10.8	9.8	9.3
Constant (1972) dollars							
Amount	1,481	1,511	1,572	1,651	1,725	1,797	1,872
Percent change, year to year	-0.2	2.0	4.1	5.0	4.5	4.2	4.2
Incomes (current dollars)							
Wages and salaries	1,341	1,498	1,682	1,863	2,051	2,241	2,439
Nonwage income	473	541	612	683	745	831	913
Corporate profits	245	242	280	321	360	400	447
Prices							
GNP deflator (percent change, year to year)	9.0	9.7	8.6	7.0	6.0	5.4	4.9
Consumer price index (percent change, year to year)	13.5	11.0	8.3	6.2	5.5	4.7	4.2
Unemployment Rate (percent, annual average)	7.1	7.5	7.2	6.6	6.4	5.9	5.6
Interest Rate (91-day Treasury bills, percent, annual average)	11.4	13.5	10.5	9.4	8.2	7.0	6.0

Figure 1.
Major Economic Assumptions

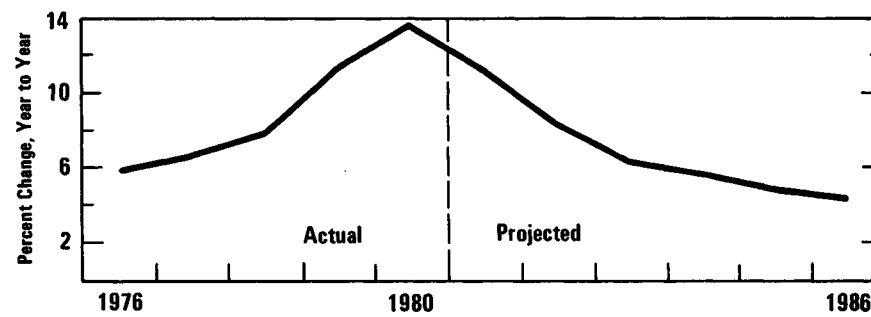
Real
Economic
Growth



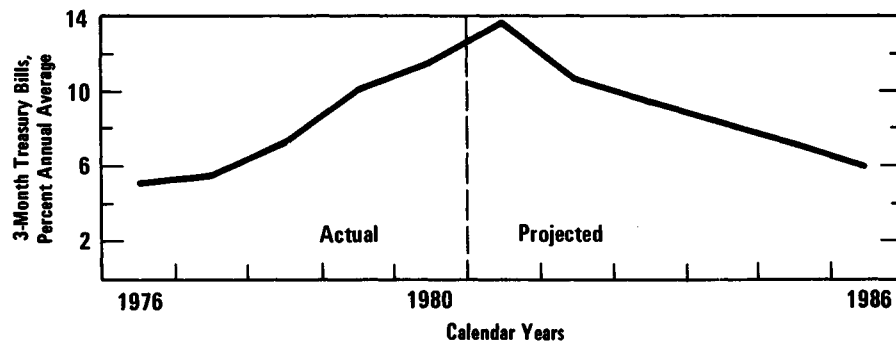
Unemployment
Rate



Consumer
Prices



Short-Term
Interest
Rate



Real economic growth is assumed to average nearly 4.5 percent over the 1982-1986 period. Inflation is projected to decline from double-digit levels in 1981 to less than 5 percent by the end of the projection period. Unemployment and interest rates also are assumed to decline steadily throughout the next five years. These assumptions reflect the view of the Administration and the budget conferees that the fiscal and monetary restraint in the President's economic program, together with the general lowering of inflationary expectations, will lead to a steady reduction in inflation and interest rates in an environment of substantial real economic growth over the next five years.

BASELINE BUDGET PROJECTIONS

The baseline projections of existing tax laws and spending policies using the budget resolution conference agreement economic assumptions are shown in Table 2.

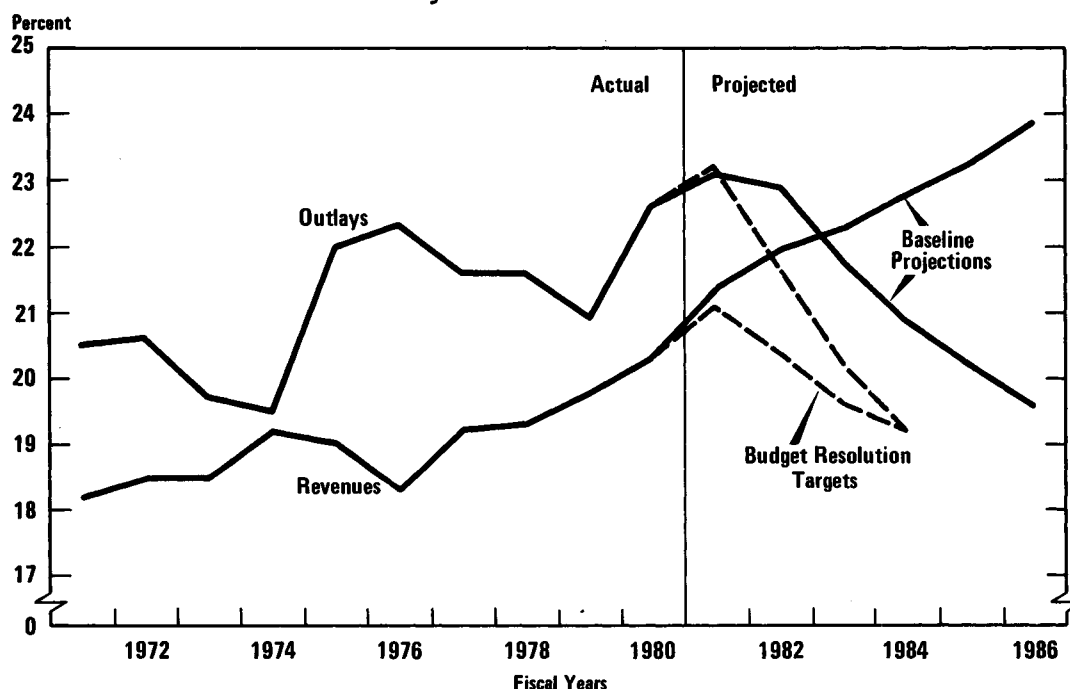
TABLE 2. BASELINE BUDGET PROJECTIONS (By fiscal year)

	1981 Base	Projections				
		1982	1983	1984	1985	1986
In Billions of Dollars						
Baseline Revenues	611.9	709.1	810.2	919.6	1,033.2	1,158.8
Baseline Outlays	659.8	738.7	792.5	843.3	894.9	949.9
Implied Deficit (-) or Surplus	-47.9	-29.6	17.7	76.3	138.3	208.9
Baseline Budget Authority	723.8	795.6	859.3	916.8	980.3	1,037.7

As a Percent of GNP						
Baseline Revenues	21.4	22.0	22.3	22.8	23.3	23.9
Baseline Outlays	23.1	22.9	21.8	20.9	20.2	19.6
Implied Deficit (-) or Surplus	-1.7	-0.9	0.5	1.9	3.1	4.3

Baseline revenues are projected to rise from \$611.9 billion in 1981 to \$1,158.8 billion in 1986, an increase of almost 90 percent in five years. This represents an annual average increase of 13.6 percent, compared with an average growth rate in federal revenues since 1976 of about 15 percent a year. Because of the progressive tax structure for individual income taxes, federal revenues under existing law would increase faster than the gross national product (GNP). Consequently, as a proportion of GNP, revenues under existing law would rise from 21.4 percent in 1981 to 23.9 percent in 1986, as displayed in Figure 2.

Figure 2.
Federal Revenues and Outlays as a Percent of GNP



Baseline outlays would increase at a slower pace than revenues during the projection period. Baseline outlays in 1986 are projected at \$949.9 billion, a 44 percent increase above the 1981 base level of \$659.8 billion. This would represent an annual average increase of 7.6 percent, which is considerably below the 11.5 percent average growth rate in federal outlays during the past 10 years. This projected growth rate for outlays is also lower than the assumed growth in GNP measured in current dollars. As a result, projected baseline outlays would fall as a percentage of GNP from 23.1 percent in 1981 to 19.6 percent in 1986.

Under baseline, or current policy, assumptions the budget would begin to show a surplus in 1983. By 1986, this surplus would grow to a sizable amount (over \$200 billion). Such a result would not be consistent, however, with the underlying economic growth assumptions. The rapid increase in tax burdens implied by existing law would slow down the economy. For the target growth assumptions to be realized, therefore, substantial tax cuts would, in all likelihood, be required to offset the interaction between inflation and the progressive income tax structure. Such tax cuts are, in fact, assumed for the first budget resolution for 1982.

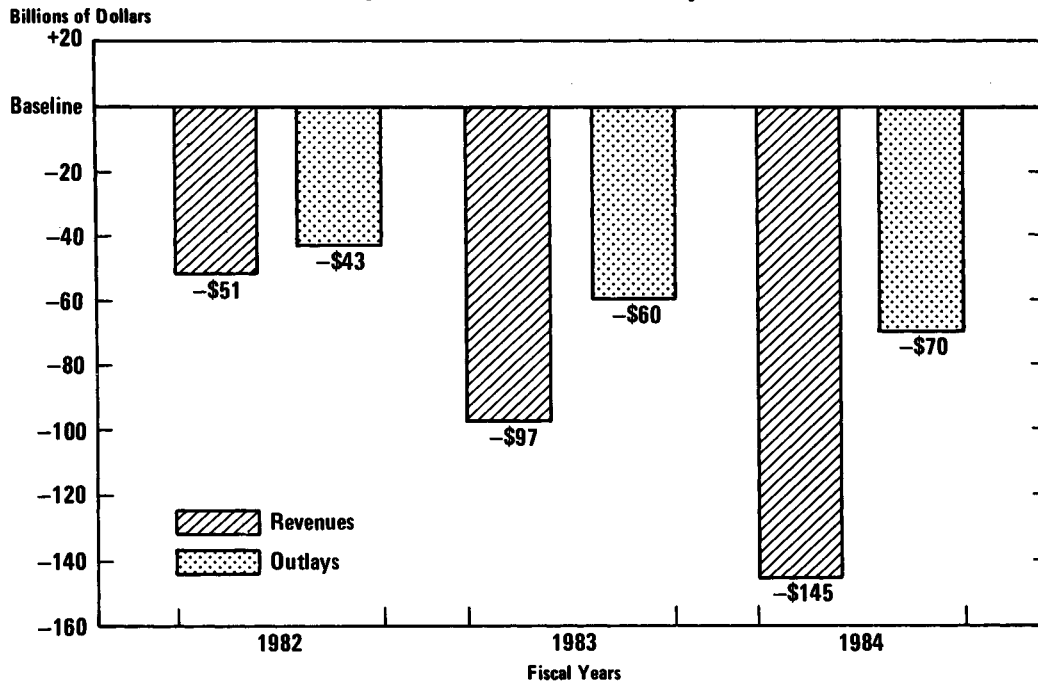
BUDGET RESOLUTION TARGETS

The first budget resolution for 1982 proposes a sharp reduction in federal spending from baseline levels and large cuts in baseline revenues, as shown in Table 3 and displayed in Figure 3. The effect of the resolution

TABLE 3. COMPARISON OF BUDGET RESOLUTION TARGETS AND BASELINE BUDGET PROJECTIONS (By fiscal year, in billions of dollars)

	1981	1982	1983	1984
Revenues				
Baseline projections	611.9	709.1	810.2	919.6
First budget resolution for 1982	603.3	657.8	713.2	774.8
Difference	-8.6	-51.3	-97.0	-144.8
Outlays				
Baseline projections	659.8	738.7	792.5	843.3
First budget resolution for 1982	661.35	695.45	732.25	773.75
Difference	1.6	-43.2	-60.2	-69.6
Deficit (-) or Surplus				
Baseline projections	-47.9	-29.6	17.0	76.3
First budget resolution for 1982	-58.05	-37.65	-19.05	1.05
Difference	-10.2	-8.1	-36.8	-75.2
Budget Authority				
Baseline projections	723.8	795.6	859.3	916.8
First budget resolution for 1982	717.5	770.9	813.75	866.45
Difference	-6.3	-24.7	-45.5	-50.4

Figure 3.
Budget Resolution Changes from Baseline Projections



spending targets would be to hold the average annual growth in federal outlays during the next three years (1982-1984) to 5.4 percent. This compares with an average annual projected growth rate of 8.5 percent under baseline assumptions for the same period and 12.5 percent since 1976. Outlays as a percentage of GNP would fall from 23.1 percent in 1981 to 19.2 percent in 1984, the lowest level since 1966.

The resolution proposes to cut taxes from projected baseline levels by even larger amounts, reducing the average annual growth in tax receipts to 8.7 percent during 1982-1984 from a projected growth rate of 14.5 percent under existing tax laws. Relative to GNP, tax revenues would fall from 21.1 percent in 1981 to 19.2 percent in 1984, a level that was last attained in 1977 (see Figure 2).

Because the resolution proposes significantly larger tax cuts than spending cuts, it would attain budget surplus one year later than the baseline projections. A similar result also would occur if the baseline revenue projections were adjusted by tax cuts sufficient to prevent rising tax

burdens resulting from the interaction between inflation and the progressive income tax structure (see Chapter III).

The proposed tax cuts and changes in spending contained in the first budget resolution are discussed in greater detail in Chapters III and IV.

RECONCILIATION INSTRUCTIONS

The conference agreement on the first budget resolution for 1982 includes reconciliation instructions to 14 Senate committees and 15 House committees to report legislation to achieve spending savings from projected baseline levels. Unlike the reconciliation instructions included in the first budget resolution for fiscal year 1981, the 1982 reconciliation instructions do not require any changes in tax legislation.

The 1982 savings included in the reconciliation instructions amount to approximately \$51 billion in budget authority and \$36 billion in outlays, as shown in Table 4. This represents a reduction of about 6 percent in budget authority and 5 percent in outlays from projected 1982 baseline levels. The reconciliation instructions direct savings to be achieved in 1983 and 1984 as well, so that the spending reductions would represent longer-term changes in policy.

TABLE 4. BASELINE BUDGET PROJECTIONS AND RECONCILIATION INSTRUCTIONS (By fiscal year, in billions of dollars)

	1981	1982	1983	1984
Budget Authority				
Baseline projections	723.8	795.6	859.3	916.8
Reconciliation instructions				
House committees	--	-50.7	-57.6	-66.0
Senate committees	-14.7	-50.7	-57.6	-66.0
Outlays				
Baseline projections	659.8	738.7	792.5	843.3
Reconciliation instructions				
House committees	--	-35.1	-46.3	-55.6
Senate committees	-2.3	-36.5	-47.0	-55.8

The House reconciliation instructions are limited to fiscal years 1982-1984 and are directed only to authorizing committees, whereas the Senate instructions include actions to be taken to reduce 1981 spending. The budget authority savings to be achieved by reconciliation actions in 1982-1984 are identical for both Houses, but the Senate's reconciliation outlay savings are somewhat greater because they include the outyear effects of the assumed 1981 reductions.

The 1982 reconciliation instructions are aimed at three types of spending authorizations: (1) permanent appropriations and other direct spending authorizations that do not require annual appropriations, (2) entitlement programs that are subject to annual appropriations, and (3) discretionary authorizations that are subject to annual appropriations.

In some instances, authority to spend may be provided directly in the authorizing legislation and does not require subsequent appropriations. Spending from most trust funds and permanent appropriations falls into this first category of authorizations. Examples of such spending include Social Security benefits, unemployment insurance, foreign military sales, Farmers Home Administration insurance funds, and various housing assistance programs. The basic substantive law usually must be changed to achieve savings in these programs. As shown in Table 5, outlays resulting from these direct spending authorizations are estimated to total \$345 billion in 1981, and are estimated to rise to \$503 billion by 1986 under the baseline projections.

The term "direct spending" as used for the reconciliation process also includes all appropriated entitlements. The term "appropriated entitlements" refers to legislation that requires the payment of benefits to any person or government meeting the eligibility requirements established by legislation, the budget authority for which is provided for in annual appropriations. In this case, however, the level of annual appropriations is mandated by existing law and generally cannot be altered through the appropriation process. Examples of appropriated entitlements include the medicaid, supplemental security income, aid to families with dependent children, and veterans' compensation and pensions programs. Outlays for this second category of spending are estimated to be \$78 billion in 1981 and are to rise to \$101 billion by 1986 under the baseline projections.

The third type of spending authorization covered by the reconciliation instructions is authorizing legislation that is funded by appropriations or other kinds of budget authority to be contained in annual appropriation acts. Such legislation may place a limit on the amount of budget authority to be included in appropriation acts or it may authorize the appropriation of "such

TABLE 5. BASELINE OUTLAY PROJECTIONS AND RECONCILIATION INSTRUCTIONS BY TYPE OF SPENDING AUTHORIZATION (By fiscal year, in billions of dollars)

	1981 Base	Projections				
		1982	1983	1984	1985	1986
Baseline Projections						
Permanent Appropriations and Other Direct Spending	345.1	392.1	421.1	449.8	476.5	503.0
Appropriated Entitlements	78.4	84.2	88.5	90.7	96.3	100.8
Discretionary Authorizations	330.2	373.0	404.1	434.7	466.0	498.9
Offsetting Receipts (not allocated to committees)	<u>-94.0</u>	<u>-110.7</u>	<u>-121.3</u>	<u>-131.9</u>	<u>-143.9</u>	<u>-152.9</u>
Total	659.8	738.7	792.5	843.3	894.9	949.9

Reconciliation Instructions a/						
Permanent Appropriations and Other Direct Spending	-0.5	-7.2	-8.7	-9.7		
Appropriated Entitlements	-0.2	-5.4	-6.5	-7.6		
Discretionary Authorizations	<u>-1.6</u>	<u>-23.9</u>	<u>-31.8</u>	<u>-38.5</u>		
Total	-2.3	-36.5	-47.0	-55.8		

a/ Reconciliation instructions for Senate committees, Conference Report on First Concurrent Resolution on the Budget--Fiscal Year 1982, H. Con. Res. 115, Senate Report No. 97-86, May 15, 1981.

sums as may be necessary." The Appropriations Committees have the discretion to include whatever level of funds they believe necessary in the annual appropriation acts to carry out the purposes of this type of authorizing legislation, up to any limit that may be specified in the authorizing legislation. Estimated outlays in 1981 resulting from such discretionary authorizations total \$330 billion. Under the baseline projections for these programs, outlays would rise to \$499 billion by 1986 (see Table 5).

As shown in Table 5, the Senate reconciliation instructions direct outlay savings of \$23.9 billion in 1982 for programs with discretionary authorizations, and \$12.6 billion in outlay savings for permanent appropriations, appropriated entitlements, and other direct spending. For 1984, the

reconciliation instructions contemplate outlay savings of \$38 billion in discretionary authorization programs, and \$17 billion in direct spending programs.

The savings to be achieved through the reconciliation process are less than the net spending cuts from projected baseline levels specified by the first budget resolution targets. This is because the resolution targets assume that other spending reductions, in addition to those included in the reconciliation instructions, will be made through the appropriation process or by other means. As discussed in Chapter IV, these additional reductions, after allowing for the spending increases in national defense programs assumed by the resolution, total \$14 billion in 1982 outlays and rise to \$46 billion by 1984.

SENSITIVITY OF THE BUDGET TO ECONOMIC ASSUMPTIONS

Changes in economic conditions can have dramatic effects for the federal budget. Actual outlays for fiscal year 1980, for example, were \$47 billion higher than estimated for the first budget resolution, and about one-third of this increase can be attributed directly to higher than expected inflation and interest rates. Forecasting future economic conditions is subject to a great deal of uncertainty, and the longer the forecast period the greater the range of uncertainty. Because of these uncertainties, questions are frequently asked about the effect of different economic assumptions on current budget estimates or on baseline budget projections.

One approach to showing the sensitivity of the budget to changes in economic assumptions is to calculate the effect of a one percentage point change in a key economic variable, such as the rate of inflation or the unemployment rate. This section provides such estimates for four variables--real economic growth, inflation, unemployment, and interest rates. Changes in economic conditions, however, do not occur in isolation. It is unlikely that a one percentage point change in one variable will occur without changes in the other variables. For example, real growth and the unemployment rate are both measures of the utilization of productive economic resources. Interest rates reflect generally held expectations of inflation, which are partially based on past and present inflation rates.

A second, and more realistic, approach to calculating the sensitivity of the baseline budget projections to changes in economic conditions is to use a fully consistent alternative set of economic assumptions. This section also provides the results of using a different set of economic projections for the five-year projection period.

One Percentage Point Change in Selected Economic Assumptions

To estimate the effects of a change in the underlying economic assumptions is a complex task. Much depends on the timing of the economic change. For example, if higher unemployment or inflation is concentrated in the last quarter of the fiscal year, the budget effects will be smaller than if the changes occur early in the year. It also makes a difference if the change in assumptions is limited to one year or affects the entire projection period.

The character of the change in the economic assumptions can be important. For example, higher unemployment can be associated with either higher labor productivity or lower economic growth. In the first case, fewer workers are employed in producing a given level of output. The effect on nominal incomes and, consequently, on revenues will be small. On the other hand, an increase in the unemployment rate caused by less rapid economic growth will mean lower nominal incomes and lower revenues.

The level of unemployment is also important for calculating the effect of a higher or lower unemployment rate for budget outlays. A one percentage point increase in the assumed unemployment rate will result in a greater change in outlays than a one percentage point decrease if the level of unemployment assumed for the projections is near the national or state trigger points for extended unemployment benefits.

The estimates in Table 6 show the budget effects of a one percentage point change beginning in January 1982 for four variables--real economic growth, inflation, unemployment, and interest rates. 1/ The one percentage point change is assumed to occur each year in the 1982-1986 projection period. The result would be to raise or lower the assumptions shown in Table 1 for these variables by one percentage point.

The estimates shown in Table 6 demonstrate the following points about the sensitivity of the budget to changes in economic conditions:

- o A reduction in real growth or an increase in the unemployment rate will lead to reductions in revenues, increases in outlays, and decreases in the budget surplus (or increases in the deficit). 2/

1/ The estimates presented in Table 6 assume that higher unemployment results from lower growth.

2/ Initially, a one percentage point decline in the growth rate, which will increase the unemployment rate by about 0.4 percentage points in the first year, will have less of an effect on the surplus than would a one percentage point increase in unemployment. After a few years, however, the persistence of the slower growth rate will cause a relatively larger decrease in the surplus.

TABLE 6. THE EFFECT ON THE BASELINE PROJECTIONS OF
SELECTED CHANGES IN ECONOMIC ASSUMPTIONS (By
fiscal year, in billions of dollars)

	1982	1983	1984	1985	1986
Real Growth: Effect of One Per-					
centage Point Lower Annual Rate					
Beginning January 1982					
Change in revenues	-5	-12	-21	-31	-44
Change in outlays	+3	+5	+13	+16	+22
Change in surplus	-8	-17	-33	-47	-66
Inflation: Effect of One Per-					
centage Point Higher Annual Rate					
Beginning January 1982					
Change in revenues	+5	+16	+30	+49	+71
Change in outlays	+1	+5	+11	+16	+23
Change in surplus	+4	+11	+19	+33	+49
Unemployment: Effect of One Per-					
centage Point Higher Annual Rate					
Beginning January 1982					
Change in revenues	-12	-17	-18	-20	-21
Change in outlays	+7	+11	+12	+13	+14
Change in surplus	-19	-28	-30	-33	-35
Interest Rates: Effect of One Per-					
centage Point Higher Annual Rates					
Beginning January 1982					
Change in revenues	--	+1	+1	+1	+1
Change in outlays	+2	+5	+6	+7	+8
Change in surplus	-2	-4	-5	-6	-7

NOTE: The one percentage point change is assumed to occur each year from the rates shown in Table 1 for calendar years 1982-1986. See Chapters III and IV for the effect on revenues and outlays of a one percentage point change for only calendar year 1982.

- o An increase in inflation will lead to increases in both revenues and outlays, but the effect on revenues will be greater so that on balance the change will lead to a larger surplus (or smaller deficit).
- o An increase in interest rates would also increase both revenues and outlays, but the revenue effect would be quite small, so that on balance the change would lead to a smaller surplus (larger deficit).

Further details on the sensitivity of revenues and outlays to economic changes are given in Chapters III and IV, respectively.

Alternative Economic Assumptions

The estimates given in Table 6 for the budget effects of a reduction in real growth and an increase in the unemployment rate are interdependent. A one percentage point decrease in the annual rate of real growth is associated with a 0.4 percentage point increase in the annual unemployment rate. No change, however, is assumed in the annual rate of inflation or in average interest rates. A reduction in real growth, however, could be the result of higher inflation and higher interest rates. Some combination of changes in the four variables from their projected paths is likely, which further complicates the task of showing the sensitivity of the budget projections to changes in the economic assumptions.

Another approach to calculating the sensitivity of the baseline budget projections to changes in economic assumptions, therefore, is to use a fully consistent alternative set of economic assumptions. CBO constructed such a set of economic assumptions for its analysis of the Administration's 1982 budget revisions.^{3/} The key assumptions are summarized in Table 7.

Under the alternative economic assumptions, real growth averages somewhat above 3 percent over the 1982-1986 projection period, compared with nearly 4.5 percent for the baseline assumptions. Inflation is assumed to decline but not as much as for the baseline assumptions. The lower real growth is offset by the higher inflation so that GNP measured in current dollars grows at about the same rate for both sets of assumptions. Unemployment and interest rates are assumed to decline steadily, but not as

^{3/} Congressional Budget Office, An Analysis of President Reagan's Budget Revisions for Fiscal Year 1982 (March 1981).

TABLE 7. ALTERNATIVE ECONOMIC ASSUMPTIONS (By calendar year)

	1981	1982	1983	1984	1985	1986
Gross National Product (GNP)						
Current dollars (percent change, year to year)	11.8	11.9	11.5	11.4	11.7	10.9
Constant (1972) dollars (percent change, year to year)	1.3	2.5	2.7	3.0	3.8	3.7
Prices						
GNP deflator (percent change, year to year)	10.3	9.2	8.6	8.1	7.5	7.0
Consumer price index (percent change, year to year)	11.3	9.5	8.9	8.2	7.7	7.1
Unemployment Rate (percent, annual average)	7.8	7.9	7.8	7.7	7.5	7.2
Interest Rate (91-day Treasury bills, percent, annual average)	12.6	13.7	11.5	10.2	9.7	9.3

much as under the baseline assumptions. The unemployment rate under the alternative economic assumptions falls only to 7.2 percent by 1986, compared with 5.6 percent under the baseline assumptions. Similarly, the 91-day Treasury bill interest rate (annual average) is projected to decline slowly to 9.3 percent by 1986, compared with a sharper decline to 6.0 percent under the baseline economic assumptions.

Projections of baseline revenues and spending under these alternative economic assumptions are shown in Table 8. The effect of the alternative economic assumptions is to increase the average annual growth rate of projected outlays from 7.6 percent under the baseline assumptions to 9.5 percent. By 1986, projected outlays would be \$1,039 billion, or \$89 billion higher than under the baseline assumptions. Lower real growth and higher inflation, unemployment, and interest rates all work together to increase outlays.

The average annual growth in revenues would also be slightly higher under the alternative economic assumptions than under the baseline economic assumptions--14.3 percent compared with 13.6 percent. The higher inflation under the alternative economic assumptions more than offsets the lower real growth, particularly in the last two years of the projection period, as real economic growth approaches the levels assumed for the baseline projections. As a result, revenues by 1986 are projected to be \$28 billion (or about 2 percent) higher under the alternative economic assumptions than under the baseline economic assumptions.

TABLE 8. BASELINE BUDGET PROJECTIONS USING ALTERNATIVE ECONOMIC ASSUMPTIONS (By fiscal year, in billions of dollars)

	1981 Base	Projections				
		1982	1983	1984	1985	1986
Baseline Revenues	607.6	706.5	805.1	915.7	1,040.3	1,187.0
Baseline Outlays	659.9	749.6	823.5	892.5	963.5	1,038.7
Implied Deficit (-) or Surplus	-52.3	-43.1	-18.4	23.2	76.8	148.3
Baseline Budget Authority	719.4	803.5	882.7	954.8	1,034.0	1,105.5

The effect of the greater increase in projected outlays than in revenues under the alternative economic assumptions would be to delay by one year the attainment of a budget surplus. The alternative baseline projections show a budget surplus beginning in 1984, which would increase rapidly in 1985 and 1986. Again, it should be noted that such a result would not necessarily be consistent with the underlying economic assumptions. The restraint that would be exerted by the budget could be too great for the economy to achieve the real growth assumptions. Nevertheless, the alternative projections serve to demonstrate the dramatic effects that changes in economic assumptions can have on budget estimates.

CHAPTER III. BASELINE REVENUE PROJECTIONS

Baseline revenues, for the purposes of this report, are those that would accrue if 1981 tax law were to remain in effect during the next five years, and if the economy were to perform according to the economic assumptions of the first budget resolution for 1982 as agreed to in conference. These baseline revenue projections are shown in Table 9.

TABLE 9. BASELINE REVENUE PROJECTIONS BY SOURCE (By fiscal year, in billions of dollars)

	1981 Base	Projections				
		1982	1983	1984	1985	1986
Individual Income Taxes	286.3	339.6	399.4	467.3	537.3	617.5
Corporate Income Taxes	66.9	69.8	82.5	93.7	104.8	118.0
Social Insurance Taxes	187.4	216.3	240.8	265.0	297.8	329.5
Excise Taxes	43.5	53.8	54.7	55.9	53.1	52.7
Estate and Gift Taxes	6.9	7.6	8.5	9.4	10.4	11.3
Customs Duties	7.5	7.9	8.3	8.8	9.1	9.3
Miscellaneous Receipts	<u>13.4</u>	<u>14.1</u>	<u>16.0</u>	<u>19.5</u>	<u>20.7</u>	<u>20.5</u>
Total	611.9	709.1	810.2	919.6	1,033.2	1,158.8

SOURCES: Projections for 1981-1984 are based on the First Concurrent Resolution on the Budget for Fiscal Year 1982. Data for 1985 and 1986 are CBO extrapolations of the 1981-1984 projections.

The baseline revenue projections are related to the revenue targets established for fiscal years 1982-1984 in the first budget resolution for 1982. The projections for fiscal years 1981-1984 were derived from these revenue targets by removing the resolution's tax reduction proposals and suggested tax increases and extensions. The projections for fiscal years 1985 and 1986 are CBO extrapolations of the revenue projections based on economic assumptions consistent with those agreed to by the conferees.

The baseline revenue projections are, in fact, inconsistent with the economic assumptions underlying them. If existing tax law were to remain in effect during the next five years, real economic growth would actually be lower than the economic growth assumed for the baseline projections. This is because the rising tax burden--resulting from the interaction between inflation and the progressive income tax as it is now structured--would slow economic growth. The budget resolution economic assumptions (shown in Table 1) were developed as part of the budget planning process and include major tax and spending cuts.

In projecting baseline revenues, all changes in tax law that are part of the present tax code are assumed to take place on schedule. The projections discussed here assume that the highway trust fund taxes will be phased out at the end of fiscal year 1984; that the targeted jobs tax credit will not be available for tax years beginning after December 31, 1981; that the \$200 interest and dividend exclusion (\$400 for joint returns) will not be available for tax years beginning after December 31, 1982; and that the investment credit for Employee Stock Ownership Plans (ESOPs) will not be available for tax years beginning after December 31, 1983.

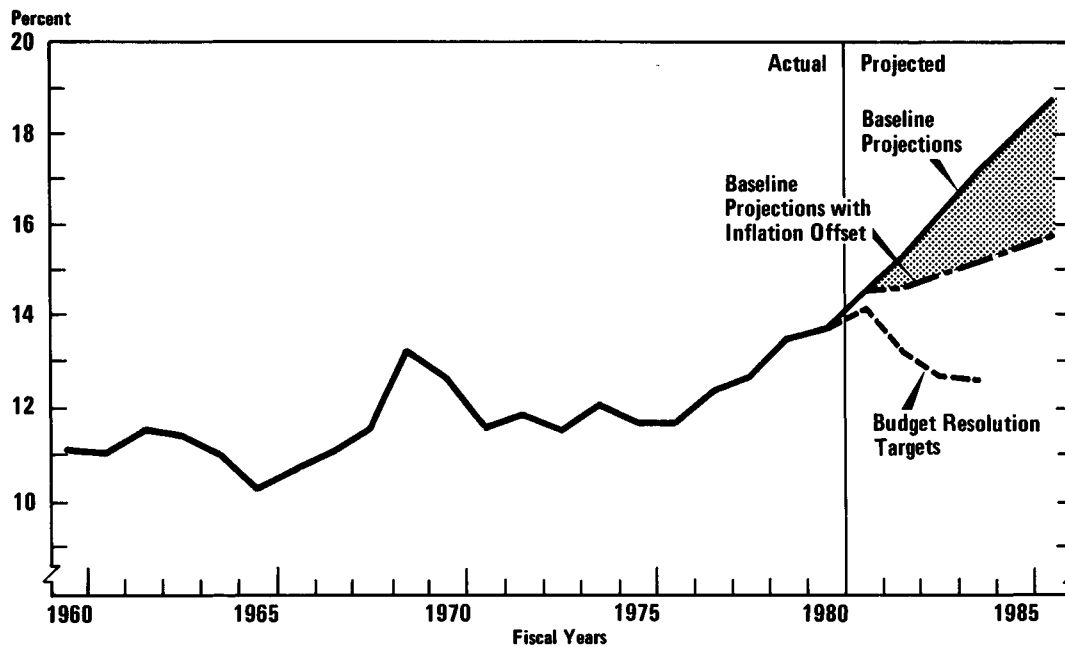
One alternative revenue baseline, also useful for policy planning purposes, would be the baseline used for this report plus the extension of tax provisions that are scheduled to expire during the projection period. This alternative is used by the Office of Management and Budget in its current services projections. ^{1/} Extension of the targeted jobs tax credit would decrease revenues by \$0.2 billion in 1982, \$0.3 billion in 1983, and \$0.4 billion in each year 1984 through 1986. Extension of the \$200 interest and dividend exclusion would decrease revenues by \$0.8 billion in 1983, \$2.5 billion in 1984, \$2.6 billion in 1985, and \$3.0 billion in 1986. Extension of the credit for ESOPs would decrease revenues by \$0.9 billion in 1984, \$1.2 billion in 1985, and \$1.2 billion in 1986. Extension of the highway trust fund taxes would increase revenues by \$3.9 billion in 1985 and \$4.0 billion in 1986. The net effect of including these extensions in the baseline revenue projections shown in Table 9 would be to decrease revenues by \$0.2 billion in 1982, \$1.1 billion in 1983, \$3.8 billion in 1984, \$0.3 billion in 1985, and \$0.6 billion in 1986.

^{1/} See Special Analysis A, "Current Services Estimates," Special Analyses, Budget of the U.S. Government, Fiscal Year 1982 (January 1981).

THE CHANGING COMPOSITION OF REVENUES

The projection of receipts under existing tax law for fiscal years 1982-1986 emphasizes the most salient characteristic of the present tax system: the high and growing share of incomes claimed by the progressive individual income tax during an inflationary period (see Figure 4). Taxpayers whose incomes do not rise faster than the general price level experience actual reductions in their real after-tax incomes. This occurs because marginal and average tax rates rise as these taxpayers move up through the tax brackets, increasing their tax liability even if their real purchasing power on a before-tax basis does not increase. This characteristic of the progressive income tax system is called "bracket creep." For this reason, and also because of the growth in Social Security taxes, revenues under existing law are projected to equal 21.4 percent of gross national product in 1981--the highest level since 1944.

Figure 4.
Individual Income Taxes as a Percent of Taxable Personal Income



NOTE: Individual income taxes are on a unified budget basis.

The composition of federal tax revenues has changed significantly over the past 30 years (see Figure 5). Individual income taxes have grown

from 39.9 percent of total revenues in 1950 to 46.9 percent in 1980. During the intervening years, income taxes have been reduced from time to time in order to contain the share of income paid in taxes. This history of bracket creep mitigated by tax reductions can be seen clearly in the up-and-down path of the ratio of income taxes to taxable personal income shown in Figure 4. (Taxable personal income equals wages and salaries, proprietors' income, rental income, dividend income, and personal interest income.)

The most rapidly growing tax source over the past 30 years has been social insurance payroll taxes and contributions, including the taxes for Social Security, unemployment insurance, railroad retirement, and civil service retirement. These combined taxes have grown steadily from 11.1 percent of total revenues in 1950 to 30.9 percent in 1980. For the most part, this growth has resulted from increases in the tax rates and maximum taxable income levels for Social Security contributions, which account for over 85 percent of total social insurance taxes.

Although corporate income taxes have continued to increase over the period, their share of total revenues has decreased significantly from 26.5 percent in 1950 to 12.4 percent in 1980. Excise taxes have also been declining as a share of the total since 1950. This trend will continue despite the increase in windfall profit tax collections projected over the next five years. In fact, recent projections of oil prices are generally lower than those on which the Administration's March estimates, which were adopted by the budget conference, were based. Therefore, it is likely that the growth of total excise taxes over the next five years will be less than that shown here.

Under existing tax law, individual income taxes would continue to increase as a share of total revenues from the high level of 46.8 percent in fiscal year 1981 to the unprecedented level of 53.3 percent in 1986. Although social insurance taxes and corporate income taxes would continue to increase during this period, their shares of the total would decrease. The share of social insurance taxes would decrease from 30.6 percent in 1981 to 28.4 percent in 1986, and that of corporate income taxes would decrease from 10.9 percent in 1981 to 10.2 percent in 1986.

These changing shares of revenues reflect the significantly different growth rates projected for the main tax sources. Between 1981 and 1984, total baseline receipts are projected to increase by 50 percent. Individual income taxes would increase by 63 percent, social insurance taxes by 41 percent, and corporate income taxes by 40 percent. By 1986, after two more years of disproportionately high growth, individual income taxes under existing tax law would be 116 percent above their 1981 level, while total receipts would have increased 89 percent.